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SUBJECT: BANK OF MEXICO CONFERENCE ON POVERTY CHALLENGES,
SOLUTIONS, AND IMPLICATIONS

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Introduction and Summary

¶1. (SBU) Mexican economic leaders and World Bank economists discussed the causes and potential solutions for the country,s persistent poverty at a July 19 Mexico City conference &Growth and Reduction of Poverty in Latin America: Virtuous Cycles and Vicious Cycles.8 At the conference, Central Bank Governor Guillermo Ortiz pointed to the need for education and human capital creation as the crux of the problem. World Bank economists Guillermo Perry and William Maloney noted the role the eighties and nineties in terms of financial crises played in suppressing incomes of the poor. They pointed as well to the temporary disparity liberalizing measures such as NAFTA create by benefiting the better off first, though such measures are essential to alleviating poverty in the long run. Most participants made the basic point that more and better jobs are key to reducing poverty. Academics also described the inequalities created by poor fiscal policies and subsidies, as well as the growing North-South divide in Mexico. Hacienda (Treasury) Secretary Gil Diaz closed the conference highlighting the success of Mexico,s economic stability and its impact on spurring private investment and reducing poverty. While the North/South PAN/PRD divide threatens to stall reform in the upcoming Congress, the poverty conference reinforced the message that the incoming Mexican government resist the temptation for short term political fixes such as subsidies and entitlements, and find the political courage to stick with fiscal reforms to cement long-term poverty reduction.

Remarks by BOM Governor Guillermo Ortiz

¶2. (SBU) BOM Governor Guillermo Ortiz opened the event with an overview of Mexico,s economy. He criticized the elevated unequal regional distribution of income, as well as deficient economic growth over the last decade. Ortiz explained that in the sixties, Mexico,s income per capita was greater than both Korea,s and Spain,s and currently their income per capita was twice Mexico,s. This, he highlighted, is the consequence of the instability generated by Mexico,s economic and financial crises of the eighties and nineties. According to a study developed by the Bank of Mexico, without

these crises, income per capita would be 70 percent greater than the current 9,000 dollars.

¶3. (SBU) Ortiz added that more efficient social programs, like the &Opportunities Program8 created to reduce poverty by benefiting the poorest communities, are substituting historic schemes of generalized subsidies, which often benefit the medium and high-income population. At the same time, he said that the government,s efforts of an increase in job creation through infrastructure development and a reduction of debt has not been sufficient to fight poverty.

¶4. (SBU) According to Ortiz, employment is key to a reduction of poverty, since human capital improvements create more and better jobs. However, the rigidity of the labor markets in Mexico threatens future employment creation. Ortiz stated that there is no tradeoff between policies geared to generating economic growth and those aimed at reducing poverty. Hence, focusing on one goal will also accomplish the other.

Results of the World Bank Study

¶5. (SBU) World Bank Chief Economist for Latin America Guillermo Perry, and William Maloney, Lead Economist presented a poverty and inequality study showing that despite the region,s rich natural resources it suffers from modest economic growth with 25 percent of the population surviving on less than 2 dollars per day. According to Perry, education is the most important factor in income difference. In Mexico, Perry explained the correlation on the years of study between parents and sons is 55 percent, which means that 45 percent of Mexican children will out earn their

parents, compared to 80 percent in the U.S.

¶6. (SBU) Perry highlighted that Latin America,s historic inertia led to the creation of exclusionary institutions reserved for the elite, and although other countries had similar histories, they subsequently invested in improving education. Perry explained, that between the fifties and the seventies, Latin America,s economic growth exceeded the current rate, but, in the eighties, other developing countries implemented a prudent macroeconomic policy, while Latin America experienced many economic crises. This led to segregation between rural and urban sectors. Urban/rural discrimination in education, investment, and research continues throughout much of the region.

¶7. (SBU) All pro-growth policies will generate a decrease in poverty in the long-term, according to Perry. Yet, in the short-term there are tradeoffs as it is easier for those with better access to take full advantage of opportunities provided. As an example, NAFTA,s effect in Mexico was positive yet uneven, as the most needy rural regions did not benefit as much or at all, while urban regions did benefit. Therefore, he concluded that the poorest regions require greater emphasis on education and investment.

¶8. (SBU) Maloney explained that education is fundamental to increasing productivity, which in turn attracts investment, improves human capital, and reduces poverty. Inequality gaps widen as investment flows first to wealthier regions.

The south of Mexico is the country,s poorest region with very low levels of education and human capital, and hence remains unattractive for investors.

¶9. (SBU) Maloney concluded that to reduce poverty levels in Mexico, economic growth is needed, however poverty itself prevents economic growth, creating a vicious cycle. Maloney explained that in Mexico an increase of poverty by 10 percent generates a 1 percent decrease in economic growth and a five

percent decrease in investment.

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Growth and Reduction of Poverty Levels in Mexico
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¶10. (SBU) In Mexico one out of every four people live in extreme poverty, according to Santiago Levy, Ex-Director of the Mexican Social Security Institute (IMSS). Levy added that a majority of those that live in the most rural areas do not own the land they live on, and those that do own land, own an average of one-third hectare. The job market in Mexico plays a central role in the reduction of poverty, as a key to reducing poverty in Mexico is the generation of productive jobs.

¶11. (SBU) Levy explained that the notion of a segmented job market does not reflect current reality, as there is a continuous and intense labor movement between the formal and informal sectors. He said that there are incentives to work in the informal sector given permanent subsidy-generating programs, hence increasing the informal market. Levy explained that government should not only focus on increasing the availability of incentives, but on "compatibility of incentives8 which he described is understanding that social policies should serve the same purposes as economic policies. He noted that incentives should be geared towards an increase in productivity, which could generate a virtuous cycle. Levy concluded that the large gap in productivity between the formal and the informal market, and the smaller size of informal businesses, contributed to Mexico,s inadequate economic growth in recent years.

¶12. (SBU) An adequate fiscal policy is an important tool for the reduction of poverty and unequal distribution of income, according to Fausto Hernandez, Economics Professor at Mexico,s Center for Economic Research and Teaching (CIDE). Hernandez highlighted that total government expenditure in Mexico is equivalent to 20 percent of GDP of which only 0.9 percent is destined for social programs, whereas in the U.S. government social expenditure is 20 percent of GDP. An improved Mexican fiscal policy could increase social expenditures, and thus reduce poverty. Hernandez added that there are four main problems with the current fiscal policy:

the size of the effort, a high proportion of fiscal resources, the net progress of fiscal instruments used, and the low efficiency of redistributive and social programs. Mexico needs a fiscal reform, as total tax collection in Mexico is only 9.8 percent of GDP, yet in order to make fiscal reform appealing to the masses the Mexican government would have to promote it as a reform to increase social expenditure.

¶13. (SBU) Subsidies in Mexico represent a great risk to the economy. For example, subsidies for electricity alone represents twice the amount of the Opportunities Program, according to Ricardo Samaniego, Economics Professor at the Mexican Autonomous Technical Institute (ITAM). Without fiscal reform it is impossible to eradicate poverty and spur economic growth. Samaniego presented four main impediments to economic growth in Mexico: low productivity, inefficiency in the financial system, inequalities in the commercial system, and the internal market. From 1980 to 1996, productivity in Mexico increased at an average of 0.5 percent per year, and from 1996 to 2003 the increase improved to 1 percent annually; therefore, as long as total factor productivity continues to lag, Mexico,s poverty problems will continue. According to Samaniego, almost half of Mexico,s total population lives in poverty and 20 percent live in extreme poverty. The richest 10 percent of Mexicans receive 35.6 percent of the country,s total earnings whereas the poorest 10 percent receive 1.6 percent. Structural changes in Mexico favor qualified and high-tech employment generating an increase in inequality; therefore, in order to

eradicate poverty, an economic policy that is at the center of political policies needs to be implemented.

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The World Bank Research,s Political Implications
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¶14. (SBU) Mexico is naturally divided between a poor South and a growing North, according to Gerardo Esquivel, Economics Professor at the Colegio de Mexico. Esquivel added that commercial openness in the long run would benefit the country, yet in the short-run it is widening the inequality gap. Esquivel suggested that unequal access to higher education in Mexico is hurting lower income youth: four out of five young adults do not attend school.

¶15. (SBU) The presidential election highlighted the politicization problem. Both frontrunners focused on discrediting the other,s vision, yet each one personified a side of the country,s situation according to Gonzalo Hernandez, Executive Secretary of the National Council of the Evaluation of Politics for Social Development. Hernandez blamed Mexico,s mediocre economic growth on a combination of factors: in the last 13 years manufacturing productivity in Mexico grew by 70 percent compared to 190 percent in South Korea, average schooling in Mexico is 7.8 years, and it takes an average of 58 days to open a business. Hernandez highlighted that improving education, infrastructure, strengthening competition, deregulating new businesses, improving capital markets, and generating macroeconomic stability are policies that generate growth and equal distribution; therefore, due to the unpopularity of reforms, these should be &buried8 under the above policies, which would be easier to approve.

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Concluding Remarks by Secretary of Treasury Francisco Gil Diaz
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¶16. (SBU) Secretary of Hacienda (Treasury) Francisco Gil Diaz stated that without maintaining economic stability, attempts to reduce poverty will not be successful, as economic stability stimulates private investment and demand and decreases currency volatility. Additionally, Gil added that Mexico is restructuring government expenditure to emphasize investment in human capital and programs to reduce poverty. In 2005, 4.7 percent of GDP was used for investment and total resources used to eradicate poverty increased by 55.9 percent.

Comment

¶17. (SBU) The conference, despite not covering much new ground, reinforced the current preoccupation by Mexican officials, business leaders, academics, and others with the persistent challenges of poverty and inequality, and its implications for the nation,s development and competitive standing in a fast-moving globalized world. We can expect more of these types of well-attended events in the months ahead as a new GOM works to define its economic and social priorities. End comment.

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